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C O N F I D E N T I A L SECTION 01 OF 03 MOSCOW 003125

SIPDIS

DEPT FOR EUR/RUS, FOR EEB/ESC/IEC GALLOGLY AND WRIGHT
EUR/CARC, SCA (GALLAGHER, SUMAR)
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SUBJECT: RUSSIAN ENERGY COMPANIES HIT BY FINANCIAL CRISIS

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SUMMARY

¶1. (C) Gazprom announced on October 22 that it may have trouble refinancing some of its debts and obtaining needed new loans. The announcement was the latest in a recent string of news indicating Russia's oil and gas sector may be seriously affected by deteriorating conditions in financial markets. According to press reports, the GOR recently responded to requests by four major Russian oil and gas companies (including Gazprom) and provided them with $9 billion in loans to help them refinance existing debt. Although the companies have all been relatively quiet about the impact of the financial crisis on their future investment plans and operations, it is becoming increasingly clear that tight credit markets will result in a reassessment of future capital expenditures by the industry. The financial crisis, combined with declining oil prices and increased government control over the sector will further hinder Russia's ability to overcome stagnating oil and gas production (reftel). End summary.

OIL AND GAS COMPANIES NOT IMMUNE

¶2. (SBU) As a part of a release of its first quarter results, Gazprom announced October 22 that financial market conditions are having an impact on the company's ability to refinance existing debts and obtain new loans. The company said it would be looking for additional financial support from the government. The news was the latest in a string of recent reports indicating that Russia's oil and gas sector is feeling the effects of the global financial crisis despite a year of record high oil prices. According to press reports, the GOR pledged $9 billion of financial assistance on October 14 to four Russian oil and gas companies (including Gazprom) that had requested support in an earlier letter to Premier Putin. Lukoil President Vagit Alekperov indicated in a press interview reported October 8 that his company, along with Gazprom, Rosneft, and TNK-BP, had appealed to the government for loans in order to refinance billions of dollars of short-term debt coming due in coming months.

¶3. (SBU) In late September, business newspaper Kommersant reported that Gazprom's oil arm, Gazpromneft, may reduce its investment budget for 2008 and 2009 by 10 to 20 percent. The paper also quoted the deputy chairman of gas company Itera as

confirming that Itera and other major oil and gas companies that had been paying 7-8 percent interest rates on ruble-denominated debt now had to pay 11-13 percent. In response, VTB bank Deputy Chairman Vasily Titov was quoted in the press as saying interest rates to "all corporate clients" had risen in line with the bank's borrowing costs.

¶4. (SBU) More recently, there were reports that several of the smaller Russian oil companies had requested tax relief on their crude exports. The companies complained (as the larger companies had previously) that they were losing money on these exports because the export duty, which lags price movements, is calculated on the higher prices of previous weeks. The companies also reportedly claimed that they could not redirect their exports to the domestic market because the projected export revenues had been used as collateral for loans.

¶5. (SBU) State-owned oil pipeline monopoly Transneft has reportedly delayed the start of the construction of the BPS-2 (Baltic Pipeline System 2), citing difficulties receiving financing. (Note: Some investment analysts actually cheered this move as value-additive given the dubious economic justification of this "Belarus bypass" project. End note.) Transneft has also reportedly sought government funds to support its $10.2 billion 2009 investment plans (up from $7.9 billion in 2008), including for the hugely over-budget East Siberian-Pacific Ocean (ESPO) pipeline.

¶6. (C) Believing that many oil and gas companies are indeed facing financial difficulties, Energy sector consultant Jerry Rohan (protect) pinned the blame on the companies themselves.

He told us recently that instead of reinvesting their windfall profits into their businesses, they used them for dividend payments and unwise acquisitions. Counting on continued high oil prices and access to easy credit, they borrowed heavily for capital expenditures and, in some cases, to cover regular operating transactions. Now, they are having trouble raising new cash to refinance those loans and do not have the cash reserves to pay them off as they come due.

INVESTMENTS TO SUFFER?

¶7. (SBU) Despite the news reports and widespread analyst sentiment, the major oil and gas companies have been largely quiet about the potential impacts of the financial crisis on their investment and operational plans and forecasts. Gazprom's cautionary note in its first quarter results was the first time the company admitted potential problems with financing. In fact, Gazprom head Alexei Miller, when recently proclaiming "astronomical" results for his company (prior to the October 22 official release), downplayed the impact of the crisis, predicting it would not negatively impact the company.

¶8. (C) Although all the major companies are reportedly reviewing their future investment plans, none has posted any information on their investor or press websites indicating downward revisions. On the contrary, some have recently projected increased capital expenditures. Following its recent board meeting, TNK-BP announced an increase in its 2008 capital expenditures from the previously approved level of $3.5 billion to $4.4 billion. COO Tim Summers (protect) indicated to us recently that the 2009 level would be similar but also admitted that given the rising cost of debt, the company was having to rely more on cash than it would like to finance its expansion plans. Press reports later quoted Summers as saying the company's 2009 capital expenditures would be between $3.5 billion and $4.5 billion. On September 28, press cited Gazprom's Deputy CEO as claiming the company's investment program calls for rising investment

expenditures over the next two years, reaching $51 billion in
¶2010.

¶9. (SBU) Many analysts are skeptical that the sector can maintain these planned investments. A UBS analyst warned in a recent note to clients that he believes major Russian oil companies are facing "severe liquidity problems" that will cause them to seek expensive new financing, or tax cuts, or to forego capital expansion. The analyst suggested the government will be unlikely to cut taxes at this time and that financing will be difficult, leaving the companies likely to delay planned investments.

¶10. (C) Leonid Grigoriev, President of the Institute for Energy and Finance also told us recently that he believed energy sector investments will be delayed because of a lack of credit. Vladimir Konovalov, Executive Director of the Petroleum Advisory Forum (the association of western oil companies), told us he believes companies will be forced to slash investments as the credit crunch compounds the effects of high input costs and onerous taxes in an era of falling oil prices.

¶11. (C) Alf D'Souza (protect), Vice President of Government Relations at Shell Russia, told us October 9 that he thinks the Russian oil companies are "desperate for cash." He said an upcoming board meeting of Salym Petroleum, Shell's JV with British firm Sibir (owned by Russian oligarchs), was delayed because the oligarchs are dealing with their financial/liquidity problems. He said the Salym JV was not in trouble itself, but that the effect of the crisis on Sibir's owners may have an impact on Salym. (Note: A Sibir press release later described certain asset sales that UBS interpreted in its analysis as a "pure cash injection" to help one of Sibir's oligarch owners avoid margin calls. End note.)

GOVERNMENT TO THE RESCUE?

¶12. (SBU) As indicated by the GOR's $9 billion package to the four major oil companies, the state may be able and willing

to support the sector as needed, at least in the near term. The GOR has already stepped up by temporarily using a shorter lag to calculate oil export taxes, saving the sector some $5.5 billion.

¶13. (C) Alfa Bank's chief strategist Ron Smith told us recently that despite the government's reduced "room for maneuver" given dropping oil prices, he believes "the sector is too critical for the overall economy" for the government to allow any hiccups in operations. He wrote in a recent note to investors that Gazprom's "surging cash flows" should cover its investment needs in the near-term, and government financing should provide a safe back-up source of funds. He repeated both these sentiments in his October 23 note, downplaying Gazprom's own cautionary statement.

¶14. (C) Deputy Speaker of the Duma Valery Yazev, a member of the energy committee and dinosaur leader of the Gazprom-financed Russian Gas Union (the gas industry trade association) reportedly told the press recently that he didn't expect any changes to major Gazprom, Rosneft, or Transneft projects, believing the government will provide needed financing for its favored champions.

¶15. (C) Government assistance would likely bring greater government influence and control. Several major oil companies recently reduced gasoline prices, for example, following government complaints that pump prices have not fallen in line with the decline in oil prices. D'Souza said he believes the government is in fact eager to provide cash to companies and is "licking its chops" to take further

control of the sector. Rohan noted that the government would largely be loaning back to the companies money it "effectively confiscated in the first place,8 referring to the punishingly high tax rates the companies face on oil exports at prices above $25 per barrel.

¶16. (C) BP Russia President Richard Spies (protect) told us October 21 that the big companies should be able to cover much of their investment needs through cash-flow, but that all companies still need access to credit markets to cover temporary shortfalls and other financing needs for their operations. He said in that regard, the frozen credit markets will affect all companies. He added, however, that their bigger worry is the declining oil price and the onerous tax regime. If the government is to help, it needs to rethink its overall policy toward the sector.

SECOND-ORDER EFFECTS

¶17. (C) Another concern for the sector may be what D'Souza called the "second-order" effects of the credit crunch. He suggested that many sub-contractors and suppliers to the oil and gas sector may also be having credit problems that could threaten their existence. He said the companies who own a field or project would then have to save their contractors or look for new ones, both costly propositions.

COMMENT

¶18. (C) Slower economic growth and a declining oil price could induce the GOR to take steps to reduce the tax burdens on the oil sector, to accelerate the elimination of gas price subsidies, to be more welcoming to foreign investments, and generally to reduce its role in the energy sector. A more likely scenario, however, is that government support for the sector will result in even greater control and that the declining economic conditions will result in the government (or certain well-placed players) squeezing even more cash out of the sector. Add into this mix lower oil prices and higher interest rates, and the near-term future of the Russian energy sector is one in which the country produces less oil and gas and invests less in upstream developments, resulting in less production in the future even if prices begin to rise again after a global recession. End comment.
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